

Service Date: February 2, 2006

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER of the Application by)	
Havre Pipeline Company to Revise and)	UTILITY DIVISION
Unbundle its Interruptible Transportation)	
Natural Gas Service, to Establish an)	DOCKET NO. D2005.4.48
Interruptible Compression Service Rate and)	ORDER NO. 6646b
an Interruptible Transportation Service)	
Rate, to Seek Approval for Re-Classification)	
of Assets)	

PROPOSED ORDER

APPEARANCES

FOR THE APPLICANT:

Havre Pipeline Company

Kimberley A. Beatty, Browning, Kaleczyc, Berry & Hoven, P.C., 139 Last Chance Gulch,
Helena, MT 59601

FOR THE INTERVENORS:

Montana Consumer Counsel

Mary Wright, Montana Consumer Counsel, 616 Helena Avenue, Room 300, PO Box
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Encore Acquisition Company

Jerome Anderson, Anderson & Baker Law Offices, PO Box 866, Helena, MT 59624
(withdrawn September 29, 2005)

Klabzuba Oil and Gas, Inc.

Marjorie L. Thomas, Dick and Thomas, P.C., 17 South Main, PO Box 645, Butte, MT

59703

NorthWestern Energy

Ross Richardson, Henningsen, Vucurovich & Richardson, P.C., 115 Granite, Butte, MT
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BEFORE:

Greg Jergeson, Chairman and Hearing Examiner

COMMISSION STAFF:

Joel Tierney, Utility Division
Al Brogan, Staff Attorney

Background

1. On April 7, 2005, Havre Pipeline Company, LLC (HPC), filed an application to revise and unbundle its interruptible transportation natural gas service, to establish an interruptible compression service rate and an interruptible transportation service rate, and to seek approval for re-classification of assets (Application).

2. Specifically, HPC requested to establish a Compression Service Rate of \$0.1352 per Mcf of natural gas that must be compressed by HPC in order to be transported and a Transmission Service Rate of \$0.0497 pr Mcf of natural gas transported within or through HPC's system.

3. HPC also requested that two compressor stations, Hill County #1 (HC #1) and Blaine County #3 (BC #3), and the pipeline between HC #1 and the KVR Compressors at Blaine County #1 (KVR) be removed from the transportation system. HPC represented that these assets should be classified as gathering assets.

4. The Montana Public Service Commission (Commission) noticed the Application on April 20, 2005. The Montana Consumer Counsel (MCC), Encore Acquisition Company (EAP), Klabzuba Oil & Gas, Inc. (Klabzuba) and NorthWestern Energy (NWE) intervened in the proceeding. The MCC, EAP and NWE engaged in discovery. EAP filed response testimony. On

September 29, 2005, EAP withdrew from the proceeding as an intervenor and withdrew its pre-filed testimony. The Commission held a hearing in this matter on October 7, 2005. HPC and Klabzuba appeared at the hearing.

5. The evidentiary record in this proceeding consists of the following:
 - a. the Application and Exhibits A-1, A-2, B-1 and B-2 thereto;
 - b. the pre-filed direct testimony of Gregory L. Henson with Exhibits HPC-1, HPC-2, HPC-3, HPC-4, HPC-5, HPC-6, HPC-8, HPC-9, HPC-10, HPC-12, HPC-13, HPC-14, HPC-15 and HPC-16;
 - c. the pre-filed direct testimony of Donald D. Fippinger with Exhibits HPC-17, HPC-18, HPC-19, HPC-20;
 - d. the pre-filed direct testimony of Paul H. Raab with Exhibits HPC-21, HPC-22, HPC-23, and HPC-24;
 - e. the pre-filed testimony of Rutherford S. Poats with Exhibits HPC-25, HPC-26, HPC-27, HPC-28, HPC-29, HPC-30, and HPC-31;
 - f. HPC's responses and supplemental responses to data requests labeled MCC-001 through MCC-071 and NWE-001 through NWE-004; and
 - g. the live testimony offered at the hearing.
6. The following items were filed but have not been admitted into the evidentiary record:
 - a. the Rebuttal Testimony of Thomas E. Hirsch III; and
 - b. the Rebuttal Testimony of Donald D. Fippinger;

SUMMARY OF THE TESTIMONY

Gregory L. Henson

7. Gregory L. Henson testified that HPC's current rates result in a revenue deficiency of \$581,285. HPC -1, p. 3, as amended by live testimony, Transcript (TR) p. 10.

8. Mr. Henson testified that HPC desired to unbundle its compression and transmission services. He justified this by stating that some customers deliver gas into the system at a pressure sufficient for the gas to be moved through the system without further compression

but that other customers deliver gas to HPC that required additional compression to be transported. HPC-1, p. 4. Mr. Henson asserted that unbundling of costs had been recognized by the Commission and is the prevailing policy in ratemaking at the federal level and with other state regulatory commissions. HPC-1, p.5. He stated that the only transportation compression included in the Application is at KVR. Response to Data Request (RDR) MCC-068.

9. Mr. Henson stated that unbundling costs and services is the prevailing policy in ratemaking at the federal level and with other state regulatory commissions. HPC-1, p. 5. He asserted that a utility's customers should only have to pay the costs associated with services the customer actually uses. HPC-1, p. 5. He also asserted that unbundling of services is the policy of the Commission. RDR MCC-018.

10. Mr. Henson sponsored Exhibits HPC-2 through HPC – 16, consisting of Statements A, B, C, D, E, F, G, H, I, J, K and Z-1.

Donald D. Fippinger

11. Donald D. Fippinger testified that in 2004 HPC transmitted 21,750,288 Mcf of natural gas through its system and compressed 17,805,403. HPC-17, p. 3. He testified that the volumes of each would be reduced on a going forward basis because certain gas that was delivered to the system from Devon Energy's CS #103 system would not be delivered in the future. HPC-17, P. 4. Mr. Fippinger projected that future volumes would be 20, 477,918 Mcf for transmission and 16,533,033 Mcf for compression. HPC-17, p. 4.

12. Mr. Fippinger also testified that he had concluded that several assets originally classified as transportation assets. HPC-17, p.5. He asserted that the compressors at Hill County #1 (HC #1) and Blaine County #3 (BC #3) and the pipeline between HC #1 and the KVR compressors at Blaine County #1 (BC #1) should be classified as part of HPC's gathering system. HPC-17, p. 7-8.

13. Mr. Fippinger sponsored Exhibits HPC-18 through HPC-20, consisting of 2004 Pipeline Throughput Volumes, Asset Classification Schematic and Statement N.

Paul H. Raab

14. On October 3, 2005, at a regularly scheduled and noticed work session, the

Commission admitted the pre-filed testimony and exhibits of Paul H. Raab and excused Mr. Raab from cross-examination. Mr. Raab's testimony was marked as HPC-21, and the exhibits consisting of Paul H. Raab Experience, Statements L and M and Revenue Deficiency were marked as HPC-22 through HPC-25.

15. Mr. Raab sponsored Statement L. Statement L is an allocated cost of service analysis. Mr. Raab stated that the three steps in allocating costs are functionalization, classification and allocation. HPC-21, p. 4. He testified that HPC maintains accounting records that allow direct assignment of costs to various functions and that the costs provided to him were already grouped by function. HPC-21, p. 4.

16. Mr. Raab stated that he did not classify HPC's costs because the costs would be directly assigned and because the HPC's requested rate design consisting only of volumetric rates did not require classification. HPC-21, p.5.

17. Mr. Raab testified that he used nine general allocation factors: (1) Direct Assignment Factors; (2) Asset Retirement Obligations; (3) Operating Expenses Factor; (4) Administrative Expenses Factor; (5) Volumes Factor; (6) Tangible Plant Factors; (7) General Plant Factors; (8) Ad Valorem Taxes Factor; and (9) Rate Base Factor. HPC-21, p. 6-7.

18. Mr. Raab provided an original and updated summary of the cost of service study. HPC-23, p. 1, RDR MCC-011. The details of that summary for HPC's regulated operations are in the table below:

	Compression	Transmission	Total
Operating Revenue	\$2,223,013	\$1,004,018	\$3,227,031
Operating Expenses			
Operating & Maintenance	\$1,523,297	\$227,558	\$1,750,855
Deprecation & Amortization	\$321,732	\$357,945	\$679,677
Taxes Other Than Income	\$79,506	\$93,709	\$173,215
Total Operating Expenses	\$1,924,535	\$679,212	\$2,603,747
Income Before Taxes	\$298,478	\$324,807	\$623,285
Income Taxes			

State Income Taxes	\$17,307	\$18,834	\$36,141
Federal Income Taxes	\$83,684	\$91,065	\$174,749
Total Income Taxes	\$100,991	\$109,899	\$210,890
Net Income	\$197,487	\$214,908	\$412,395
Total Rate Base	\$2,184,571	\$2,377,272	\$4,561,843
Rate of Return	9.04%	9.04%	
Volumes	16,533,033	20,477,918	
Rate (\$/Mcf)	\$0.1345	\$0.0490	

Ronald S. Poats

19. On October 3, 2005, at a regularly scheduled and noticed work session, the Commission admitted the pre-filed testimony and exhibits of Rutherford S. Poats and excused Mr. Poats from cross-examination. Mr. Poat's testimony was marked as HPC-26, and the exhibits consisting of Education & Professional Experience, Devon Energy Earnings Release FY 2004, Capital Structure, Business Unit Segmentation, Comparative Annualized Yield, Comparative Implied Cost of Equity and IBES Growth Forecasts were marked as HPC-27 through HPC-33.

20. Mr. Poats testified that he used a two-stage Discounted Cash Flow (DCF) method to determine the cost of equity for a group of publicly traded gas transportation companies. HPC-26, p. 3. The proxy companies were Equitable Resources, Inc., Kinder Morgan Inc., National Fuel Gas Co., and Southern Union Co. HPC-26, p. 3.

21. Mr. Poats testified that HPC's capital structure consisted of 43.1% debt and 56.9% equity, HPC-26, p. 3 and HPC-29, and that this was reasonable relative to the proxy company group that had a mean equity ratio of 49% and median equity ratio of 51%. HPC-26, p. 5.

22. Mr. Poats testified that HPC's cost of debt was 4.47% on December 31, 2004. HPC-26, p. 6.

23. Mr. Poats testified that the range of reasonableness for return on equity indicated by the proxy companies was 9.3% to 13.4% with a mean of 11.6% and a median of 11.8%. HPC-26, p. 16. Mr. Poats did not adjust the cost of equity for variations in financial risk. HPC-26, p.

16. However, Mr. Poats argues that HPC faces more business risk than the proxy companies and that proxy group's risk-adjusted range is 11.8% to 13.4%. HPC-26, p.17-18. He maintains that HPC's requested return on equity of 12.5% is near the midpoint of the proxy group's risk-adjusted range. HPC-26, p. 18.

DISCUSSION AND FINDINGS OF FACT

Unbundling of Rates

24. HPC requests authorization to charge separately for compression and transmission on its transportation system.

25. In a natural gas pipeline system compressor stations are normally located every 40 to 100 miles to boost the line pressure. Compression is, therefore, a normal function of transportation. Although Mr. Henson asserted that unbundling of costs and services is the prevailing policy in federal ratemaking, he did not cite a single instance of separate compression and transmission rates. *C.f.* RDR MCC-018 (Both *Kern River Gas Transmission Co.*, 96 F.E.R.C. ¶ 61,137 (2001) and *PG&E Gas Transmission Northwest Corp.*, 97 F.E.R.C. ¶ 61,101 (2001) dealt with insulating existing shippers from subsidizing compressor station upgrades. Neither case addressed a separate compression rate. The cases used different structures to deal with potential fuel cost increases. The different approaches were based on each respective company's method of assessing fuel costs.)

26. HPC stated, "unbundling is the policy of the [Commission]" and cited *Montana Power Co.*, Docket No. 90.1.1, Order 5474c (October 3, 1991). RDR MCC-018. HPC overstates the conclusions that can be drawn from Order 5474c. The section of the order that HPC cited is a discussion of arguments offered by proponents of an unbundled transportation rate. The section does contain the Commission's analysis or conclusions. Furthermore, HPC is attempting to extend a concept beyond its limited application.

27. Absent special circumstances, imposing separate charges for compression and transmission is inappropriate.

28. Natural gas delivered to HPC and Blaine County #4 (BC #4) and Blaine County #5 (BC #5) is transported to the Many Islands delivery point which is not part of HPC's Montana

intrastate system. The natural gas from BC #4 and BC #5 does not pass through any compressors on HPC's system. There is no testimony regarding the distance from BC #4 or BC #5 to Many Islands. However, the maps included in HPC's application suggest that the distance from BC #4 to Many Islands is about 30 miles and the distance from BC #5 to Many Islands is less than 20 miles.

29. Although there is testimony that the natural gas delivered to HPC through BC #4 and BC #5 is at a high enough pressure to be delivered to market, there is not testimony as to the actual pressure at which the gas is delivered. The suggested distance between BC #4 and BC #5 on one hand and Many Islands on the other hand is consistent with the testimony that no additional compression is needed.

30. If the entire requested revenue requirement were recovered through a single transportation rate, the rate would need to be \$.1576/Mcf. A comparison total projected payments by customers indicates that one customer will pay approximately 30% less and all others will pay between 10% and 14% more with unbundled rates rather than a single transportation rate. If the natural gas delivered to through BC #4 and BC #5 bypassed the HPC system the single transportation rate would need to be \$.1952/Mcf. Further analysis indicates that each of the customers with increased payments will pay less with unbundled rates than the customer would pay if the natural gas from BC #4 and BC #5 did not enter the system.

31. The HPC system demonstrates special circumstances that justify separate rates for compression and transmission.

Reclassification of Assets

32. HPC requested authorization to reclassify the compressor stations at HC #1 and BC #3 and the pipeline between HC #1 and KVR from transportation asset to gathering assets.

33. Gathering is the process of taking natural gas from wells and moving it to a collection point for further movement. *Williams Gas Processing – Gulf Coast Co., L. P. v. FERC*, 331 F.3d 1011, 1013 (D.C. Cir. 2003) (citing *Conoco Inc. v. FERC*, 90 F.3d 536, 539 n.2 (D.C. Cir. 1996)). The transportation system generally includes main lines, lateral lines and compressor stations.

34. In 1995, HPC petitioned the Federal Energy Regulatory Commission (FERC) for a declaratory ruling that all of the then-existing facilities now part of HPC's system were gathering facilities, or alternatively, a combination of gathering facilities and intrastate pipeline facilities. *Northern Natural Gas Co.*, 71 F.E.R.C. ¶ 61,292, ¶ 62,150 (1995). FERC determines whether facilities are gathering or transportation by applying the modified "primary function test" and considers all other relevant facts and circumstances, including non-physical criteria. *Northern Natural Gas Co.*, 71 F.E.R.C. at ¶ 61,155. The modified primary function test includes consideration of the following factors: (1) the extension of the facility beyond the central point in the field, (2) the location of compressors and processing plants, (3) the length and diameter of the line, (4) the location of wells along all or part of the facility, (5) the facility's geographic configuration and (6) the operating pressure of the line. *Id.* No one factor is determinative and all factors do not necessarily apply in every situation. *Id.*

35. FERC found that HC #1 and BC #3, and the pipelines downstream from them, were beyond the central point of the field. *Id.* FERC found the location of the compressor stations was not relevant. *Id.* FERC found that "the facilities downstream of the compressor stations consist of three single, large-diameter pipelines many miles in length that are not connected to any wells. *Northern Natural Gas Co.*, 71 F.E.R.C. at ¶ 62,156. FERC ruled that the facilities downstream of the inlet of the compressor stations were transportation facilities. *Id.*

36. HPC asserts that operations have changed since the FERC issued its ruling. The changes include replacing the compressor at HC #1, TR p. 29; installing compressors at Hill County #2, Hill County # 3, and Sterling, TR p. 29; rerouting pipes to bypass the compressor at HC #1, TR. p.30; and two compressors were added upstream of BC #3, TR p. 41.

37. Operating pressure upstream of the HC #1 and BC #3 is lower than in 1995. TR pp. 29, 33. The pressure downstream from the compressor is the same as at the time of the FERC ruling. TR p. 34. The pipe downstream from HC #1 and BC #3 is the same size, 12-inch diameter, as it was at the time of the FERC ruling. *Compare* TR p. 34 and *Northern Natural Gas*, 71 F.E.R.C. at ¶ 62,150. Gas from BC #3 goes either through KVR to Many Islands or is delivered to NorthWestern Energy. TR p. 40. No wells connect to the pipeline downstream of HC #1. TR p. 37.

38. Under the totality of the circumstances, the Commission determines that HC #1, BC #3 and the pipeline between HC #1 and KVR remain transportation facilities.

39. FERC found that HC #1, BC #3 and the pipeline between HC #1 and KVR were part of an intrastate pipeline. *Northern Natural Gas*, 71 F.E.R.C. at ¶ 62,156. Only because the Commission regulated the rates and charges of HPC was HPC exempt from FERC regulation. *See* 15 U.S.C. § 717(c) (2005). If the Commission were to rule that HC #1, BC #3 and the pipeline between HC #1 and KVR were gathering facilities, it would be in direct conflict with FERC. In addition to its own conclusion, the Commission declines to contradict FERC in this matter.

Revenue Requirement

40. HPC requested rates designed to generate \$3,227,031 annually or which \$2,223,013 would be compression and \$1,004,018 would be transmission. The details of the requested revenue requirement are set forth in paragraph 18, *supra*.

Depreciation & Amortization Expense

41. The depreciation and amortization expense includes \$87,682 of depreciation of an acquisition adjustment over original cost of assets allocated to compression and transmission. RDR MCC-060. The depreciation is allocated 48% (\$42,087) to compression and 52% (\$45,595) to transmission.

42. In its response to MCC-060, HPC stated “The \$1,513,157 premium was approved by the Montana Public Service Commission when it approved Havre Pipeline’s original transportation rate in 1995.”

43. On September 20, 1995, HPC filed an application for initial rates and charges. The application was assigned Docket No. D95.9.136. In the application HPC included in rate base an acquisition adjustment of \$1,513,157 and requested a return on equity of 14.5%. On September 26, 1995, at 8:04 a.m., HPC made a Supplemental Filing in which it argued that it should be allowed to amortize the acquisition adjustment over a 15-year period. The minutes of a September 26, 1995 Commission meeting contain the following with respect to Docket D95.9.136: “Commissioner Rowe moved to authorize initial transmission tariffs based on 12%

ROE and without acquisition adjustment. Commissioner Anderson seconded the motion, which passed unanimously.” On September 26, 1995, at 4:50 p.m., HPC filed tariffs based on 12% return on equity but which did not eliminate the acquisition adjustment. HPC has not adjusted its rates since 1995.

44. Section 69-3-109, MCA, provides in part:

The commission may, in its discretion, investigate and ascertain the value of property of each public utility actually used and useful for the convenience of the public. The commission is not bound to accept or use any particular value in determining rates. However, if any value is used, the value may not exceed the original cost of the property, except the commission may include all or some of an acquisition adjustment for certain property purchased by a public utility in the purchasing utility’s rate vas if the transfer of property to the purchasing utility is in the public interest.

45. The Commission disallows \$87,682 of the depreciation and amortization expense.

46. The depreciation expense includes \$9,143 (\$4,328 compression, \$4,815 transmission) of depreciation of general plant assets that have been fully depreciated. RDR MCC-011 and RDR MCC-055.

47. The Commission disallows \$9,143 of the depreciation and amortization expense.

Income Taxes

48. The requested revenue requirement includes \$210,890 of state and federal income taxes (\$100,991 for compression and \$109,899 for transmission).

49. HPC is a limited liability company. HPC does not pay income tax. TR p. 13. The members of HPC include their allocated share of HPC’s income and expenses when calculating their income taxes. TR p. 13.

50. A public utility organized as a corporation pays income taxes on its income, and the corporation’s shareholders pay income taxes on any dividends received from the public utility. Under well-established ratemaking principles, only the corporation’s taxes, not those of its shareholders, are recoverable in rates.

51. Regulatory agencies are divided as whether a pass-through entity may include an allowance for income taxes in utility rates. *Compare. Policy Statement on Income Tax Allowances*, 74 Fed. Reg. 25,818, 25,824 (2005) (“[FERC] concludes that an income tax

allowance should be afforded all jurisdictional entities, provided that the owners of pass-through entities have an actual or potential income tax liability.”); *In the Matter of the Petition of Boone County Utilities, L.L.C., for a Certificate of Public Convenience and Necessity to Render Public Water Utility Service in a Rural Area in Boone County, Indiana*, No. 40341, 1996 Ind. PUC LEXIS 441, at *5 (December 6, 1996) (“The Company has elected Limited Liability Company form of ownership, and has elected to be taxed as a partnership. Accordingly, there is no provision for income taxes at the limited liability company level.”); *In the Matter of the Application of Missouri Gas Co. for Authorization to Convert to a Limited Liability Co. and Change its Name Accordingly*, No. GN-2003-0016, 2002 Mo. PSC LEXIS 1642, at *3-*4 (December 3, 2002) (“Missouri Gas agrees to give Staff and the Office of the Public Counsel its tax information and tax information of its members if it files a general rate increase”); *Washington Util. & Transp. Comm’n v. Ranier View Water Co.*, No. UW-010877, 2002 Wash. UTC LEXIS 323, at *10 (July 12, 2002) (“ . . . the tax liability [of a pass-through entity] should be imputed at the lower of the personal or corporate tax schedules.”); and *Application of St Croix Valley Natural Gas Co. for Authority to Increase Natural Gas Rates*, No. 5320-GR-104, 2005 Wisc. PUC LEXIS 617, at *4 (October 11, 2005) (“The Commission concludes that SCV as an S corporation may not receive an allowance for income taxes.”)

52. The Commission bases a public utility’s revenue requirement on reasonable, necessary and prudent expenses incurred during a test year plus adjustments for known and measurable changes.

53. HPC did not incur any income tax expense during the test year of 2004.

54. HPC requested an income tax allowance equal to 41% of its Income before Taxes (35% Federal, 6% State). RDR MCC-011. HPC stated that it used Devon Energy’s corporate tax rate for federal and state taxes. TR p. 14. However, Devon Energy Corp./DE (Devon), in its Form 10-K filed with the Securities and Exchange Commission on March 8, 2005, stated, “Devon’s 2004 effective financial rate attributable to continuing operations was an expense of 34% compared to an expense of 23% in 2003.” Form 10-K, p. 43 (March 8, 2005). In the United States, Devon had income of \$2,264 million and incurred federal taxes of \$692 million (\$473 million current, \$219 million deferred) and state taxes of \$31 million (\$10 million current,

\$21 million deferred). Form 10-K. p. 97 (March 8, 2005). Calculations indicate that Devon's effective domestic tax rate is 31.9%. When Devon was asked to provide effective income tax rates for each of its members it both objected and represented that it did not have the information. RDR MCC-059.

55. HPC did not show that the income tax of its members for 2004 to be a known and measurable item.

56. The Commission disallows the \$210,890 claimed income tax allowance.

Rate Base

57. HPC requested a rate base of \$4,561,843 of which \$2,184,571 is allocated to compression and \$2,377,272 is allocated to transmission. RDR MCC-011.

58. Included in HPC's requested rate base is \$526,098 of acquisition adjustment (\$252,527 compression and \$273,571 transmission). RDR MCC-060.

59. As discussed in paragraph 43, *supra*, the Commission disallowed any acquisition adjustment in 1995. The Commission disallows inclusion of the \$526,098 in rate base.

60. Included in HPC's requested rate base is \$93,942 of additions in 2004. RDR MCC-016. Of this amount, \$77,174 (\$36,040 compression, \$41,134 transmission) is attributable to construction work in progress (CWIP). RDR MCC-011.

61. CWIP represents investment in plant that is not actually used and useful. Plant does not become actually used until it is placed in service. A public utility in Montana may only include in rate base the value of property that is actually used and useful. *See* § 69-3-109, MCA.

62. The Commission disallows inclusion of the \$77,174 in rate base.

Rate of Return

63. HPC requested a 9.04 % rate of return. The requested rate of return is the sum of the weighted costs of capital – 1.93% on debt (4.47% time 43.1%) and 7.11% on equity (12.5% times 56.9%).

64. HPC used a two-stage discounted cash flow analysis (DCF) to determine the appropriate return on equity. The DCF method is used by FERC to determine a rate of return on common equity for natural gas pipelines. *Williston Basin Interstate Pipeline Co.*, 104 F.E.R.C. ¶ 61,036, ¶ 61,099-100, (2003). The Commission approves the use of the two-stage DCF

methodology in this docket.

65. The inputs of a two-stage DCF analysis are (1) the dividend yield, (2) the short-term growth rate and (3) the long-term growth rate. Because HPC is not a publicly traded company with dividends, the first two inputs are calculated using a proxy group of companies. HPC chose a proxy group consisting of Kinder Morgan Inc., Equitable Resources, Inc., National Fuel Gas Co. and Southern Union Co. HPC-26, p. 8.

66. In the 2003 Order cited by Mr. Poats, FERC stated that only three companies met the criteria it had formerly used to select proxy companies. *Williston Basin Interstate Pipeline Co.*, 104 F.E.R.C. at ¶ 61,103. FERC chose a proxy group based on companies listed among the Value Line group of diversified natural gas companies that owned FERC-regulated natural gas pipelines. *Williston Basin Interstate Pipeline Co.*, 104 F.E.R.C. at ¶ 61,104. The proxy group consisted of Coastal Corp., Columbia Energy, El Paso, Enron, Equitable Resources, Kinder Morgan, National Fuel Gas, Questar and Williams. *Williston Basin Interstate Pipeline Co.*, 104 F.E.R.C. at ¶ 61,113.

67. In 2005, FERC found that five of the companies included in the 2003 Order, Columbia Energy, Coastal Corp. El Paso, Enron and Williams, should be excluded from the natural gas pipeline proxy group *High Island Offshore System, L.L.C.*, 110 F.E.R.C. ¶ 61,043, ¶ 61,155-56 (2005). In decisions on natural gas pipeline rates issued after January 1, 2005, FERC has used a proxy group consisting of Kinder Morgan, Inc. Equitable Resources, Inc., National Fuel Gas Co. and Questar Corp. *See Cranberry Pipeline Corp.*, 112 F.E.R.C. ¶ 61,268 (2005) (allowing 10.58% return on equity); *Bay Gas Storage Co., Ltd.*, 111 F.E.R.C. ¶ 61,345 (2005) (allowing 10.39% return on equity); and *High Island Offshore System, L.L.C.*, 110 F.E.R.C. ¶ 61,043 (allowing 11.22% return on equity).

68. HPC chose not to include Questar and to include Southern Union in its proxy group. Value Line classifies Southern Union as a natural gas distribution, not as a diversified natural gas company. HPC-26, p. 9. However, due to acquisitions and dispositions, the proportion of Southern Unions operating income from transportation and storage grew to 63.4% in 2004 from 6.8% in 2003. *See Southern Union Co.*, 10-K, filed March 16, 2005.

69. The Commission approves the proxy group selected by HPC in this docket.

70. Southern Union does not pay a cash dividend. HPC-31. The company pays a 5% stock dividend (1.05:1 stock split). *See* Southern Union Co., 10-K, filed March 16, 2005.

71. HPC calculated Southern Union's dividend rate to be 7.69%. HPC-31. Mr. Poats grossed up the 5% dividend rate to reflect a 35% tax rate ($5.00/(1-.35)=7.69$). HPC asserts that such a gross-up is necessary to put stock dividends on the same basis as cash dividends. RDR MCC-040.

72. The gross-up is unsupportable on two grounds. First, there is no evidence in the record that investors demand a higher rate of stock dividends than cash dividends. There is no comparison of relative dividend yields for stock dividends versus cash dividends. Stock dividends, unlike cash dividends, permit the investor to select the timing of an income recognition event. Presumably, this flexibility has value. Second, the actual income tax rate on dividends is not 35%. The dividend tax rate is either 5% or 15% depending on a taxpayer's tax bracket. *See* I.R.C. § 1.

73. The Commission finds that the correct dividend yield for Southern Union is 5.00%

74. HPC calculated the dividend yield for cash dividends by dividing the annual dividend by the average stock price for each of the preceding 12 months and averaging the monthly results. HPC-31. HPC stated that its authority for using an average monthly yield was prior opinions from FERC. RDR MCC-039.

75. FERC uses the preceding 6 months of data, not the preceding 12 months. *See, e.g., Williston Basin Interstate Pipeline Co.*, 84 F.E.R.C. ¶61,081, ¶61,382 (1998) (rejecting a requested 12-month period and using a six-month period).

76. The Commission determines that a six-month period is appropriate. Applying this determination to the data in HPC-31, and using monthly averages from October 2004 through March 2005, the Commission finds that the following are the cash dividend yields:

Company	Annualized Yield
Kinder Morgan, Inc.	3.92%
National Fuel Gas	3.97%
Equitable Resources, Inc.	2.63%

77. HPC used I/B/E/S to determine short-term dividend growth for each company in the proxy group. HPC-32. The Commission finds these estimates to be reasonable.

78. To calculate long-term GDP growth, HPC used the average of Congressional Budget Office and Energy Information Administration estimates (EIA). HPC-31. HPC calculated a long-term average GDP growth of 5.15%. HPC-31 (presented as 5.2% due to rounding). The Commission finds this estimate to be reasonable but cautions HPC that in future applications it should estimates of GDP growth that are generally used in natural gas pipeline rate cases at FERC, EIA, DRI/McGraw Hill and the Social Security Administration.

79. The formula used by FERC for calculating the implied return on equity is $k = (D(1+0.5g)/P) + g$, where k = return on equity, D = annual dividend, g = growth and P = average stock price. *Cranberry Pipeline Corp.*, 112 F.E.R.C. at ¶ 62,239. HPC used this same formula without stating it as such. HPC-31. This formula can also be stated as $k = Y(1+0.5g) + g$, where Y = annualized dividend yield. The Commission adopts this formula.

80. The results of applying the formula to the data found to be reasonable are presented in the following table:

Company	Annualized Yield	Growth	Return of Equity
Kinder Morgan, Inc.	3.92%	9.38%	13.49%
National Fuel Gas	3.97%	5.05%	9.12%
Southern Union Co.	5.00%	4.38%	9.49%
Equitable Resources	2.63%	8.38%	11.12%

Mean			10.80 %
Median			10.31%
Minimum			9.12%
Maximum			13.49%

81. In Order 414-A, FERC ruled return on equity for a natural gas pipeline company should be set at the median of the proxy group. *Transcontinental Gas Pipe Line Corp.*, 84 F.E.R.C. ¶ 61,084, ¶ 61,427 (1998). Since that order FERC has repeatedly ruled that its “risk analysis assumes that pipeline generally fall into a broad range of average risk, absent **highly unusual** circumstances that indicate anomalously high or low risk as compared to other pipelines.” *High Island Offshore System, L.L.C.*, 110 F.E.R.C. at ¶ 61,161 (emphasis added). A party seeking an adjustment from the median must make a very persuasive case of a substantial difference in risk between the pipeline and the proxy group to support a deviation from the median. *Northwest Pipeline Corp.*, 92 F.E.R.C. ¶61,287 ¶ 62,006 (2000).

82. HPC asserts that it faces more business risk than the proxy group because its “business fortunes are tied to gas production by third parties,” its “throughput is directly based on the production from natural gas wells closely connected to its pipeline system” and its “customer contracts are all for interruptible service with no minimum level of volumes.” HPC-26, p. 17.

83. In responding to discovery, HPC admitted that all of the proxy group companies had business fortunes tied to gas production by third parties. RDR MCC-035. Furthermore, over 99% of both compression and transmission volumes come from affiliated parties. *See* RDR MCC-062 and Supplemental RDR MCC-005.

84. In *Highland Offshore System, L.L.C.*, the applicant’s expert testified the applicant faced a higher risk because of lack of firm service and throughput would decline as reserves in the Gulf of Mexico were exhausted. *High Island Offshore System, L.L.C.*, 110 F.E.R.C. at ¶ 61,161. FERC rejected the applicant’s claim stating:

HIOS also has not shown that its business risk exceeds the business risks if the diversified natural gas companies in the proxy group Even though large volumes of interruptible transportation are moving on HIOS, which would seem to increase its business risk, in fact those volumes are shipped by captive shippers who have no alternative means to bring gas to market. If HIOS throughput does decline, HIOS can file a new rate case to increase rates.

Id.

85. HPC's case that it faces more business risk than the proxy group is akin to the case presented by HIOS. HPC has not demonstrated that its shippers have alternatives. HPC has not demonstrated that it cannot increase rates if throughput declines. HPC's witness asserted that it is differentiated because of "sole-source risk" (RDR MCC-035) but did not compare and contrast HPC's business risk with that of the proxy group. HPC has not presented evidence of the presence of highly unusual circumstances or made a very persuasive case of a substantial difference in risk. HPC's business risk is within the broad range of business risk of the proxy group.

86. The Commission finds that a return on equity equal to the median of the proxy group, 10.31% is reasonable.

87. The Commission finds that a rate of return of 7.79% is reasonable. The allowed rate of return is the sum of the weighted costs of capital – 1.926% on debt (4.47% time 43.1%) and 5.866% on equity (10.31% times 56.9%).

Authorized Revenue Requirement & Rates

88. Subject to the adjustments required in paragraph 89, *infra*, HPC is authorized to establish rates as set forth in the table below:

	Compression	Transmission	Total
Operating Revenue	\$2,025,819	\$789,746	\$2,815,295
Operating Expenses			
Operating & Maintenance	\$1,523,297	\$227,558	\$1,750,855
Deprecation & Amortization	\$275,317	\$307,535	\$582,852
Taxes Other Than Income	\$79,506	\$93,709	\$173,215
Total Operating Expenses	\$1,878,120	\$628,802	\$2,506,922
Income Before Taxes	\$147,699	\$160,674	\$308,373
Income Taxes			
State Income Taxes	\$0	\$0	\$0
Federal Income Taxes	\$0	\$0	\$0
Total Income Taxes	\$0	\$0	\$0
Net Income	\$147,699	\$160,674	\$308,373
Total Rate Base	\$1,893,004	\$2,062,567	\$3,958,571
Rate of Return	7.79%	7.79%	
Volumes	16,533,033	20,477,918	
Rate (\$/Mcf)	\$0.1225	\$0.0386	

89. As discussed above, the Commission disapproves HPC's request to reclassify HC #1, BC #3 and the pipeline between HC #1 and KVR from transportation to gathering. HPC did not include in its rate request the operating expenses, depreciation or rate base values associated with these assets. The Commission finds that these items should properly be included in calculating HPC's revenue requirement. HPC is authorized, subject to Commission review, to increase the compression rate to account for HC #1 and BC #3 and the transmission rate to account for the pipeline between HC #1 and KVR. HPC is required to make a compliance filing showing the amounts that each item in the above table is increased to account for these assets. HPC is cautioned that none of the acquisition adjustment allocated to these assets should be included in rate base.

Other Issues

90. The evidence in this docket suggests that HC #2, HC #3, the Stirling Compressor Station and the Frick Compressors at BC #1, along with assorted pipeline facilities, were added to the system since 1995. The record in this docket does not establish whether those assets are transportation or gathering assets. Nothing in this order should be construed as determining the proper classification of those assets or as approving or disapproving of HPC's classification.

91. The Commission has recently determined that natural gas pipelines are within the definition of common carrier in § 69-13-101, MCA. *See In the Matter of the Application of Westech Energy Corp. for an Order Recognizing it as a Regulated Common Carrier*, 21 MAR 2263 (November 10, 2005). The Commission has not considered the effect of this determination on HPC's gathering system. HPC's transportation system is regulated as a public utility pursuant to a declaratory ruling. *In the Matter of the Petition of Havre Pipeline Co., LLC for a Declaratory Ruling on Public Utility Status*, 16 MAR 1670 (August 24, 1995). Nothing in this order should be construed as determining whether or not HPC's gathering system is a common carrier.

92. The Commission infers that since 1995, HPC has collected nearly \$238,000/year more than the Commission authorized. This is the sum of the annual amortization of the acquisition adjustment and the authorized rate of return times the acquisition adjustment. Had HPC filed an application for permanent rates after it had an operating history, this over-collection likely would have been avoided. Likewise, had the Commission not closed Docket 95.9.136, this likely would have been avoided. The Commission recognizes that the current managing member of HPC was not the managing member in 1995. The Commission concludes that under the specific facts of this case it would be unjust to require HPC to refund over-collections dating back to 1995.

93. All conclusions of law that can properly be considered findings of fact and should be considered as such to preserve the integrity of this order are incorporated herein as such.

CONCLUSIONS OF LAW

1. The Commission regulates the rates and services of public utilities. Title 69, Chapter 3, MCA.

2. HPC is a public utility subject to the jurisdiction of the Commission. § 69-3-101, MCA.

3. The property values ascertained herein are the reasonable values of public utility property actually used and useful for the convenience of the public. § 69-3-109, MCA.

4. The rate levels approved herein are just, reasonable and not unduly discriminatory. § 69-3-330, MCA.

5. HPC is not required to refund over-collections due to errors in its rates. § 69-3-330(2), MCA.

6. All findings of fact that can properly be considered conclusions of law and that should be considered as such to preserve the integrity of this order are incorporated herein as such.

ORDER

It is hereby ordered:

1. HPC is authorized to establish an interruptible compression service rate and an

interruptible transmission service rate.

2. HPC is authorized to establish a compression service rate to collect \$2,025,189 plus the operating expenses and 7.79% of the net book value of HC #1 and BC #3 on a volume of 16,533,033/Mcf. Any portion of the rate in excess of \$0.1225/Mcf is subject to the Commission's review.

3. HPC is authorized to establish a transmission service rate to collect \$789,476 plus the operating expenses and 7.79% of the net book value of the pipeline facilities between HC #1 and KVR on a volume of 20,477,918/Mcf. Any portion of the rate in excess of \$0.0386/Mcf is subject to the Commission's review.

4. HPC is ordered to file compliance tariffs pursuant to this order within 21 days of the date of hereof.

5. HPC is ordered to make a compliance filing at the same time as it files compliance tariffs documenting the operating expenses and net book value of HC #1, BC #3 and the pipeline between HC #1 and KVR.

6. To the extent that HPC has implemented its requested rates subsequent to January 7, 2006 (9 months from the filing date) and to the extent that the requested rates exceed the final rates allowed in this order, HPC is ordered to rebate the difference plus interest calculated at 7.79% per annum.

7. HPC is ordered to comply with each and every directive of the Commission in the body of this order.

DONE AND DATED THIS 1st day of February, 2006

GREG JERGSON, Chairman